INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute and regulations involved	2
Statement	4
Argument	7
Conclusion	12

CITATIONS

Cases:

Bingham, Trust of, v. *Commissioner,* 325 U. S. 365	8, 10, 11, 12
Commissioner v. *Heide,* 165 F. 2d 699	7, 8, 9, 12
Commissioner v. *Heininger,* 320 U. S. 467	10, 11, 12
Dobson v. *Commissioner,* 320 U. S. 489	10, 11, 12
Heide v. *Commissioner,* 8 T. C. 314	10

Statutes:

Act of June 25, 1948, Public Law 773, 80th Cong., 2d Sess., Sec. 36	12
Internal Revenue Code, Sec. 23 (26 U.S.C. 1946 ed., Sec. 23)	2, 7

Miscellaneous:

S. Rep. No. 1559, 80th Cong., 2d Sess., p. 13	3
Treasury Regulations 103, Sec. 19.23 (a)-15	12

In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 346

ESTATE OF HYMAN Y. JOSEPHS, DECEASED, ARTHUR C. JOSEPHS, EXECUTOR, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court of the United States (R. 11-25) is reported in 8 T. C. 583. The opinions of the Court of Appeals (R. 70-80) are reported in 168 F. 2d 233.

JURISDICTION

The judgment of the Court of Appeals was entered on May 20, 1948. (R. 80.) On August 17, 1948, Mr. Justice Jackson extended the time for

filing a petition for a writ of certiorari to October 19, 1948. (R. 83.) The petition for a writ of certiorari was filed on October 11, 1948.[1] The jurisdiction of this Court is invoked under 28 U.S.C., Sec. 1254.

QUESTION PRESENTED

Whether the sums paid by the taxpayer in settlement of suits charging him as administrator with mismanagement of an estate and as attorney's fees in that litigation, are deductible expenses within the meaning of Section 23 (a) (2) of the Internal Revenue Code, as amended.[2]

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Section 121 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

* * * *

---

[1] The taxpayer filed an earlier petition (No. 225) on August 16, 1948, which was dismissed by order of this Court on October 18, 1948, on motion of counsel for the petitioner. The reason for the dismissal was that the taxpayer died after his petition was filed. His executor filed the present petition on October 11, 1948.

[2] In the Tax Court the taxpayer maintained, in the alternative, that he was entitled to the deduction under Section 23 (a) (1) of the Internal Revenue Code, as amended. The Tax Court found it unnecessary to pass upon the question, but the court below remanded the case to the Tax Court to determine whether the taxpayer was in fact carrying on a trade or business while acting as administrator, within the meaning of Section 23 (a) (1). (R. 77.)

(2) *Non-trade or non-business expenses.*—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

* * * *

(26 U.S.C. 1946 ed., sec. 23.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:[3]

SEC. 19.23(a)-15 [as added by T. D. 5196, 1942-2 Cum. Bull. 96]. *Nontrade or Nonbusiness Expenses.—(a) In General.*—Subject to the qualifications and limitations in Chapter 1 and particularly in section 24, as amended, an expense may be deducted under section 23 (a) (2) only upon condition that:

(1) it has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income; and

(2) it is an ordinary and necessary expense for either or both of the purposes stated in (1) above.

* * * *

[3] While Section 19.23(a)-15 of Treasury Regulations 103 was subsequently amended, the amendments do not affect the provisions quoted above.

STATEMENT

The facts as found by the Tax Court (R. 12-16) may be summarized as follows:

In May, 1930, the taxpayer and two others were appointed administrators of the estate of Ignatz Freimuth, deceased. (R. 13.) The estate consisted chiefly of a retail department store in Duluth, Minnesota, and also included real estate, stocks, bonds, and cash. (R. 12.) Shortly after their appointment, the administrators formed a Delaware corporation to which they transferred the estate's assets in exchange for the capital stock of the corporation. (R. 13.) The taxpayer served as a director of the Delaware corporation for about three and one-half years and until the administrators formed a Minnesota corporation, to which the assets of the Delaware corporation were transferred. The common stock of the Minnesota corporation was issued to the administrators, but the taxpayer was neither a director nor officer of this corporation. Details of the operation of the Minnesota corporation were left to one of the taxpayer's co-administrators, David Freimuth, a son of Ignatz Freimuth. The taxpayer was frequently consulted on financial matters concerning the store and was often consulted by the heirs with respect to the estate affairs. (R. 13-14.)

In December, 1939, some of the heirs of Ignatz Freimuth filed a petition in the State Probate Court objecting to the manner in which the estate

was being administered and asking for an accounting and other relief. At that time the taxpayer advised the attorney retained to close the administration of the estate that he would forego compensation as administrator if his waiver would aid in the settlement of the controversy with the heirs. (R. 14.)

In March, 1940, the taxpayer and his co-administrator filed an accounting of their administration in the State Probate Court.[4] Some of the heirs filed objections to the accounting, charging misconduct and waste on the part of the administrators. In August, 1940, the administrators filed a final accounting of their administration in the State Probate Court. The heirs who had objected to the previous accounting renewed their charges of misconduct and waste. The final accounting of the administrators was approved by the Probate Court. (R. 14-15.) The dissatisfied heirs appealed to the State District Court. (R. 16.)

In February, 1941, the heirs commenced an independent action in the State District Court against the administrators, the corporation, and others charging mismanagement of the estate by the administrators and praying for damages. The defendant administrators' demurrer to the complaint in this action was sustained. The heirs appealed to the Supreme Court of Minnesota. (R. 16.)

---

[4] The third administrator died pending the administration, and a successor was never appointed. (R. 13.)

In 1941, while both appeals were pending, the parties to the litigation reached an agreement for settlement. The pending appeals were dismissed; the final accounting of the administrators approved; and the taxpayer paid $10,000 for full release from all liability asserted against him in the suits brought by the heirs, and, in connection with the litigation, paid attorneys' fees of $1,500. (R. 16.)

The Tax Court, with three judges dissenting (R. 19-25), decided that the taxpayer was entitled to the deduction of the sums in question on the ground that Section 23 (a) (2) of the Internal Revenue Code, as amended, permits the deduction of expenditures which are directly connected with or proximately result from an income-producing activity or from an activity consisting of the management of income-producing property. The Tax Court did not reach the question whether the taxpayer was entitled to the deduction under Section 23 (a)(1) of the Internal Revenue Code. (R. 16-19.)

The Commissioner appealed to the Court of Appeals for the Eighth Circuit, which, with Judge Sanborn dissenting, reversed the decision of the Tax Court on the ground that it was not enough that an expense be paid or incurred in connection with an income-producing activity in order to fall within the first class of deductions allowed by Section 23 (a) (1), but the expense must be neces-

sary to and paid or incurred for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income. (R. 76.) The court below remanded the case to the Tax Court to determine whether the taxpayer was engaged in carrying on a trade or business while acting as administrator, within the meaning of Section 23 (a)(1). (R. 77.)

ARGUMENT

1. The decision of the court below is correct. The Tax Court construed Section 23 (a)(2) of the Internal Revenue Code, as amended, *supra,* to mean that if an expenditure was directly connected with the taxpayer's services as administrator of an estate it was deductible, and held that since the sums in question were paid in settlement of a suit for mismanagement of the estate and for attorney's fees in that litigation, they were connected with his services as administrator and were therefore deductible within the meaning of the statute. The flaw in this holding is that these expenses resulted from the mismanagement, not from the management, of the estate; they were avoidable and therefore not necessary to either the production of income or to the management of property held for the production of income within the meaning of the statute. There is no reason to believe that Congress intended to permit deductions which would have the effect of subsidizing fiduciaries who violate their trust obligations. See *Commissioner* v.

Heide, 165 F. 2d 699, 701 (C.C.A. 2d). That the taxpayer was negligent in his duties as fiduciary is indicated by the substantial amount paid in settlement in addition to the fact that he waived commissions over a period of ten years (the Tax Court having found that he expected to be paid for his services (R. 16)). See *Commissioner* v. *Heide, supra.*

The court below followed the construction of Section 23 (a) (2) laid down by this Court in *Trust of Bingham* v. *Commissioner,* 325 U. S. 365, 374, that in order to come within the statute the expenditures must be either ordinary and necessary expenses paid or incurred for the production of income, or ordinary and necessary expenses paid for the management, conservation or maintenance of property held for the production of income. Section 19.23 *(a)*-15 of Treasury Regulations 103, *supra,* adopts the same interpretation of the statute, and it is significant that this Court did not question the correctness of this part of the Regulations in *Trust of Bingham* v. *Commissioner,* although it did hold (p. 377) that another provision in the regulation was invalid. Since it cannot be said that the mismanagement of the estate was necessary for the production of income or for the management of the property, the court below correctly held that the taxpayer was not entitled to the deduction. *Commissioner* v. *Heide, supra.*

2. There is no conflict of decisions. The only other court decision in a similar case since the enactment of Section 23 (a)(2) is *Commissioner* v. *Heide, supra,* and that case is in accord with the decision of the court below. In that case the taxpayer was one of four trustees under four trusts created by his father; remaindermen and beneficiaries filed objections to the trustees' accounts, alleging that in some instances securities had improvidently and negligently been exchanged, or had negligently been held after depreciation and default. The court referred the issue to a referee, who held hearings, but before whom the parties eventually settled their controversies by a stipulation which the court approved, under which the trustees were to resign, to abandon any claims for commissions, and to pay $3,000 to the corpus of each trust. Accompanying this stipulation, the referee filed an opinion, in which he declared that on the evidence he was unable to decide whether or not the trustees had been negligent in the sense that they had made themselves personally liable. The taxpayer sought to deduct the $3,000 under Section 23 (a)(2), which the Tax Court permitted him to do; the Second Circuit reversed the Tax Court on the ground that since the taxpayer could have avoided the expenditure, it was not necessary within the meaning of the statute. The court below held that the facts in the *Heide* case are not dis-

tinguishable from the facts here (R. 76), and followed the decision of the Second Circuit.

It may be noted that Judge Sanborn in the court below based his dissenting opinion on the fact that in the present case the Tax Court made no finding that the taxpayer mismanaged the trust estate. (R. 78.) But neither did the Tax Court make such a finding in the *Heide* case. *Heide* v. *Commissioner,* 8 T. C. 314. The circumstances of the settlement of the litigation in the *Heide* case did not differ in any material respect from the settlement in this case.

The taxpayer argues that the decision of the court below is in conflict with the decisions of this Court in *Trust of Bingham* v. *Commissioner, supra; Commissioner* v. *Heininger,* 320 U. S. 467; and *Dobson* v. *Commissioner,* 320 U. S. 489. (Pet. 6.) All of these cases involve substantially different facts. In the *Bingham* case the taxpayer was a trust, and the expenses in question were counsel fees for contesting tax deficiencies, and for legal advice in connection with the payment of one of the cash legacies and with other problems arising upon the expiration of the trust and relating to the final distribution of the trust fund among the residuary legatees. The Government did not question these expenses on the ground that they were not necessary within the meaning of Section 23 (a) (2), but only on the ground that they were not paid for the production of income. In the instant case the ex-

penditures did not relate to the routine duties of a fiduciary as they did in the *Bingham* case, but they arose out of the neglect or mismanagement on the part of the taxpayer.

In the *Heininger* case the taxpayer had for twelve years been selling false teeth through the mails; in 1938 he was charged with fraudulent use of the mails, which resulted in the issuance of an order by the Postmaster General that money orders to the taxpayer should not be paid and letters addressed to him should be returned marked "fraudulent". Since this would have destroyed the taxpayer's business, he sought an injunction against the order, which was granted by the District Court, but dissolved by the Circuit Court of Appeals, and certiorari was denied by this Court. All of this cost the taxpayer $36,600 in attorney's fees and legal expense, for which he took a deduction in his 1938 return. The Commissioner denied the deduction. This Court held that the taxpayer was entitled to the deduction on the ground that it was an ordinary and necessary expense of taxpayer's business under the circumstances of that case. That case is obviously quite different from the instant case.

The *Dobson* case involved the question of whether the taxpayer realized income through the recovery of sums previously deducted as losses, which is entirely different from the instant case. With respect to the rule of the scope of review laid down

in that case,[5] it is not applicable here because this case involves a question of statutory construction. See *Trust of Bingham* v. *Commissioner, supra; Commissioner* v. *Heininger, supra; Commissioner* v. *Heide, supra.* It may be noted that in the court below both parties concurred that the decision of the Tax Court was reviewable. (R. 72.)

CONCLUSION

The decision of the court below is correct, and there is no conflict of decisions. The petition for a writ of certiorari should be denied.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

THERON LAMAR CAUDLE,
Assistant Attorney General.

ELLIS N. SLACK,
MORTON K. ROTHSCHILD,
Special Assistants to the Attorney General.

NOVEMBER, 1948.

---

[5] The rule as to the scope of review laid down in the *Dobson* case was repealed by Section 36 of the Act of June 25, 1948, Public Law 773, 80th Cong., 2d Sess., which became effective September 1, 1948. S. Rep. No. 1559, 80th Cong., 2d Sess., p. 13.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1948 813448 3-10